

COMMODITY FUTURES TRADING COMMISSION

"AGRICULTURAL OPTIONS"

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P R O C E E D I N G S

MR. DIAL: Once again, for those of you who've just come in within the last few minutes, I apologize that we didn't start exactly at 1:30, but Greg Kuserk from our division of economic analysis, as I told the other folks, got up way before breakfast this morning and flew from Baltimore to San Francisco and then they delayed his shuttle over, and he hadn't had anything to eat except airplane food, so I told him to grab a quick sandwich, because I didn't know how stout your questions were going to be. So we wanted Greg to be fully fortified.

As always, I'm delighted to have the opportunity to participate in the mid-year meeting of the National Cattlemen's Beef Association. I was visiting with Debbie when we came in here to check the equipment, and I remarked that I've seen a tremendous amount of changes as well as all of you in this room since I first joined. It was then the American National Cattlemen's Association back in the '60's. And it's all to your credit and the leadership of many of you in this room.

I need to tell you at the very beginning that the views that I'm going to express are those of my own and do not necessarily reflect those of the Commodity Futures Trading Commission or its staff.

As the schedule indicated, this is an open public meeting, held by the Commodity Futures Trading Commission for

the purpose of bringing new information concerning agriculture trade options, more specifically the ban or prohibition that CFTC has on agriculture trade options, and a forum for you to ask questions and to express your points of view. It is being recorded, as you have observed, and we'll take these tapes back to Washington and make a transcript of it, so your comments will be included in the public record that the Commission will review.

I'm Commissioner Joe Dial of the Commodity Futures Trading Commission. I'm joined today by Greg Kuserk of the Commissions' Division of Economic Analysis. Once again, on behalf of the Commodity Futures Trading Commission, I'd like to thank the NCBA for providing the opportunity for this open public forum on agricultural trade options.

As you may know, on June 9, 1997, the Commission published an advance notice of proposed rulemaking concerning the current prohibition on agricultural trade options. The advance notice posed a number of questions relating to whether the Commission should lift its prohibition on agricultural trade options, and if so, under what conditions. As part of its consideration of this issue, the Commission held open meetings in Bloomington, Illinois on July 10 and Memphis, Tennessee on July 16, 1997. This was a precedent-setting activity on the part of the Commission because all five commissioners attended both of these open hearings.

In light of the particularly high level of interest in this issue by various segments of agriculture and the direct impact this decision could have on producers, the Commission held those regional meetings to give those most affected by this issue an opportunity to address the Commission directly.

For this same reason, I was happy to accept NCBA's invitation to participate in this open public forum to allow cattlemen and other members of the public an opportunity to ask questions and express their views on this important topic.

As was the case with the open meetings in Bloomington and Memphis, a transcript of this meeting will be included in the public comment file on the advance notice of proposed rulemaking. While the public comment period officially closed on July 24, I would note that the Commission routinely considers all comments received prior to the time it actually makes its decision on such proposals, and I assure you that the comments arising from this forum will receive the same consideration as those from the other two earlier forums.

At this point, I'd like to set the stage and provide some general background on agricultural trade options by sharing with you the explanatory opening statement that CFTC Chairperson Brooksley Born presented at the opening of the Bloomington and Memphis meetings.

Generally, commodity options must be traded on a designated futures exchange. One exception to this general rule permits trade options to be traded off-exchange. Trade

options, thus, are off-exchange options offered to a commercial entity where the transaction is for a business-related purpose. Such off-exchange trade options are prohibited in certain specified agricultural commodities. These include wheat, cotton, rice, corn, soybeans and livestock. Many, but not all, of the agricultural commodities subject to the prohibition on off-exchange trade options are the subject of futures and options contracts that are actively traded on futures exchanges.

The Commission previously has examined whether to modify the prohibition on agricultural trade options and decided, as a matter of fact back in 1992, to retain the prohibition. However, the Commission has received a number of requests to take a fresh look at the issue from several agriculture-related organizations. These requests are premised on the belief that once fully implemented, recent changes to Federal programs relating to agricultural price supports and price stabilization will increase the need for innovative methods of risk shifting and price protection and that trade options may offer one such tool.

The Commission has begun this process of reviewing the agricultural trade option prohibition in response to those requests. Representatives of a broad cross section of agricultural interests and of the futures industry, as well as academics, considered this issue at a public round table hosted by the Commission. Many of the round table

participants expressed varying levels of support for relaxing the prohibition on agricultural trade options. Some participants, however, still expressed reservations over the wisdom of lifting the prohibition. Subsequently, the Commission directed its staff to study the issue and to report its findings. That public round table was held on December 19, 1995.

On May 14 of this year, the Commission's Division of Economic Analysis forwarded to the Commission for its -- excuse me. The Commission's Division of Economic Analysis forwarded to the Commission its study. The study describes the possible increased need for risk management by those engaged in agriculture resulting from recent changes to government programs relating to agriculture. In addition, it identifies the potential benefits of agricultural trade options, their potential risk, and a number of possible regulatory restrictions to address those risks.

The division's primary recommendation was that the Commission should consider whether to lift the prohibition subject to appropriate conditions. Based upon the division's analysis and recommendations, the Commission published its advance notice seeking comment in this issue. In publishing this advance notice of proposed rulemaking, the Commission has not thereby made a decision to lift the prohibition on agricultural trade options. Rather, the Commission has merely taken the step of opening the issue for debate. The

Commission will consider carefully the responses that it receives before it decides whether or not to propose to lift the prohibition.

The Commission takes seriously the advice and views expressed by those affected by its rules. We're here today to listen and learn from you so that we can make an informed decision. Our determination on whether to lift or modify the prohibition and if so, with what attendant regulatory conditions, will take into consideration all of the views and advice that we hear expressed at this meeting and submitted to us in written comments.

Of course, if based upon that record, the Commission does propose to lift or modify the prohibition, before any such proposal were to become a final rule, it would be fully aired and debated and would be subject of an additional period for public comment.

With that in mind, I would like again to thank NCBA for providing this forum and all of you for taking time to share your knowledge and experience with the Commission. We greatly depend upon the expertise of informed members of the public in reaching our decisions.

We will begin with a brief presentation by Mr. Kuserk on the issues identified by the Commission's Division of Economic Analysis in its staff study and some--not all, but some--examples of agricultural trade options. After that, we'll open up the floor for questions and comments.

Greg?

MR. KUSERK: Thank you, Commissioner Dial.

It is a pleasure to be here today, and for a while there, I wasn't sure I'd be here at all.

What I'd like to do is hand out a couple of things. Commissioner Dial referred to the advance notice of proposed rulemaking, and I have some copies of those, and then I also have some copies of examples that we'll discuss shortly here. So let me just hand these out first.

I guess we can kind of see that. Okay, as Commissioner Dial mentioned, the Division of Economic Analysis did a study of policy alternatives relating to agricultural trade options and other types of risk shifting contracts. The full study--or part of the study is--actually an abridged version--is in the advance notice of proposed rulemaking. The full study is available over the internet if you have access to the internet at the address there. It's listed right here. And I can give that to any of you later if you'd like. You could also contact the Commission if you wanted to get a hard copy of the study.

Before I go into summarizing the study and some of the results and things that we found there, what I'd like to do first is go through some examples of what an ag trade option might look like, and I've give you that in a hand-out. These--I should caution you that these examples--they're hypothetical examples; I would also say they're fairly simple



examples of what an ag trade option might be. If you look at trade options in other markets like metals or oil or in the financial markets, you might see examples of trade options that are much more complicated with much more complex pay-outs than what we're going to discuss here.

So if we look at the first example. The first example I have is a put option between a feedlot and a packer. So, for instance, in this case, on July 25, a feed lot buys a put option from a packer for 80,000 pounds of live cattle. The option gives the feed lot the right, but not the obligation, to sell 80,000 pounds of cattle for December delivery to the packer, and it sets a price of 72 cents per pound. Now for that option, there'll be a 1.52 cents per pound charge which is the option premium. This would be a payment that the feed lot would make to the packer at some point. Now in this option, the feed lot can exercise the option at any time before December of 1997. If he exercises the option before that point, the contract would turn into a forward contract. If he waits all the way to the end, it might become like a spot type contract. If he decides to exercise, he would notify the packer of his intention, and at the time in December when the delivery time would be due, he would receive the 72 cents per pound for this option--or for the cattle. If the producer did not exercise the option before the exercise date, the option would expire, and there would be no obligation to deliver any cattle to the packer. But, the feed

lot would still have to pay the packer the 1.52-cent charge for the premium. Now there may be different ways in which that premium's charged; it could be that it's taken off the price when the cattle's delivered, or it could be that there's just a payment that's made up front or at the time the option expires. That would be something that would be up to the two parties to the contract to decide how that payment for that premium--when that payment would take place.

The second example of a trade option, in this case, would be between a soybean producer and a bank. In this case, what we'd have is a cash settled option that would take place between the producer and the bank. In this case on June 27, the producer buys this cash settled put option on 15,000 bushels of soybeans from the bank. A put option usually gives you the right to--it gives the purchaser the right to put the, in this case, soybeans to the opposing party of the option, in this case, the bank. But as I said, this is a cash settled option, so there would be no actual delivery of soybeans; it would be just settled in cash.

The way the option would work, it would be a cost of the option to the producer of 11-3/4 cents per bushel, giving you a total premium of \$1,726.50. If, on November 1, the settlement price of soybeans for November delivery is below \$6.00 a bushel, the bank would pay the producer the difference between \$6.00 and the futures settlement price. So for example, on November 1, if the November futures contract

settles at \$5.20 per bushel, the bank pays the producer 80 cents a bushel for a total of \$12,000. If the price of soybeans on November 1 is greater than \$6.00 per bushel, the bank would pay nothing to the producer. Again, in this case, the producer who's the purchaser of the option, would always have to make the payment of the premium to the bank.

Okay, the third example that illustrates a commercial entity buying a call option in order to cap the cost of an input. In this case, we have the example of a cattle breeder and a feed lot. On July 25, the feed lot buys a call option from a breeder for 80,000 pounds of feeder cattle. The option gives the feed lot the right to call for the October delivery of 80,000 pounds of feeder cattle from the breeder at a price of 82 cents per pound. If the futures price on October 1 is below 82 cents a pound, the feed lot is under no obligation to purchase cattle from the breeder; the feed lot would be free to go out and negotiate with any breeder for a lower price than the 82 cents a pound, and that would include the breeder that he initially had the option contract with. Again, there'd be a premium involved, in this case, it'd be a 2.3 cent per pound premium for a total of \$1,840.00. So basically, by using this type of option, the feed lot knows that it wouldn't pay more than .82 cents a pound to acquire the feeder cattle.

The fourth example that I have is an example that's similar to example three, except in this case we have a bank

involved again. This case is between the feed lot and the bank. In the example I have here, the feed lot is wishing to hedge its cost of expected feed corn purchases, so it goes out and buys a cash settled call option from the bank for 10,000 bushels of corn. The option requires the bank to pay the feed lot the difference between the price of December '97 corn and \$2.60 per bushel, if the price of the corn futures contract on December 1 is above \$2.60 a bushel. If the price is below \$2.60, as with the other example involving the bank, there'd be no payment to the feed lot. The cost of the option would be 10 cents per bushel for a total cost of \$1,000. So in this way, the feed lot, by entering into this type of option--if the costs of corn go higher--he's going to be able to--this option would be exercised, and he would receive a payment to offset that higher feed cost that he'd have.

Example number five shows the sale of a call by a producer. In the case of a producer buying a call, what happens is that they set a ceiling on the price that would be paid for the commodity that would be delivered. Now, in some sense, that's typically not what a producer would like to do to set a ceiling, but in this case, in exchange for setting the ceiling on the cost of, in this case, corn, he would receive the premium payment from selling this option to the elevator. So in this example, it's for 10,000 bushels of corn at a price of \$2.70 per bushel, less the basis, if the corn is delivered. What would happen in this case is between a corn

producer and an elevator--if the elevator chooses to exercise the option, it would notify the producer of its intention to exercise; the elevator would receive the corn for \$2.70 a bushel. In this case, the premium was 5.5 cents, so the producer would receive the 5.5 cents per bushel--in this case, it would be a total of \$550.00--so the \$550.00 would be added to the \$2.70 a bushel that he would receive under the option.

Example number six. This example is an example of buying a call on cottonseed. The reason I chose cottonseed here is because cottonseed that doesn't--or actually, this is cottonseed oil--cottonseed oil--oh, it's not cottonseed. But typically, cottonseed is a contract--that's not traded on an exchange, so this is to give you an example of how somebody might use something for a commodity where there are no exchange alternatives. This case just shows an oil mill that buys a call option from a cotton ginner, gives the mill the right, but again not the obligation, to purchase 50 tons of cottonseed at a price of \$130 per ton. The option can be exercised at any time during the month of November. In return for the option, the oil mill pays the ginner \$3.55 for a total of \$177.50. In this case, I have the payment being made at the time the option is entered into. Again, if the option is not exercised, the seller of the option receives the premium and the option would expire worthless, then, for the oil mill.

The final example is what I've referred to here as a revenue protection contract, and this is one area that we've

heard a lot of interest in as far as why people would like to see the ag option ban lifted. Because revenue protection contracts are contracts that are not available on an exchange.

You do have yield contracts and futures contracts, which you might be able to combine to give you some sort of revenue protection, but you don't have a contract that you'd actually be able to use directly to hedge revenues.

In this case, the producer is essentially buying a put option on the revenue of corn production, and it's buying this option, in this case I have, with a bank. The way this contract would work is it would combine--it would look at yield, and it would look at like some USDA yield figures that are released in combination with the price to determine a certain revenue when you multiply those two together to come up with a strike price. So in this case, I've come up with basically a strike price of \$16,250; this would be for corn at \$2.50 per bushel for a yield of 130 acres per bushel times 50 acres. So this would be for a set amount of acres. The strike price is \$16,250; the premium, in this case, would be \$4.00 per acre, giving you a total premium of \$200.00. Now the way to see whether the option is in the money or would pay off would be to construct a table that shows various combinations of yield and price, so that you see, as the price of the corn falls--from \$2.70 down to \$2.50 to \$2.30--the amount of the pay-out would increase; likewise, as yield falls, looking at the table this way, the pay-out increases.

But you have some combinations--for instance, a low price and a high yield--where there would be no pay-out on this option.

So, in a sense, the option can go in and out of the money depending upon yield or price--how the two of them combine to give you a certain revenue. So that would be the example of a revenue protection contract, and like I said, in this case, it would be with a bank, and the bank would simply make a payment then to the producer, depending upon where the final USDA estimates of yield and the price of futures for corn--where they eventually wound up during the exercise period of the contract.

So those are just some examples of how different types of options might be used by various parties.

What I'd like to do now is to go on and talk a little bit about some of the benefits that we identified in the study of using options.

The first benefit we identified was the variety of sources that would be available to offer option instruments. Notably, first handlers of commodities--people like elevators.

When we've talked to people, we've found that a lot of producers would like to deal with their local elevators; they have ongoing business relationships with them; they know their options, so that they feel that they're more familiar with these people and that they'd rather deal through them as opposed to dealing on the exchange.

Another source for option instruments might be banks. Banks also kind of represent a natural business partner for farmers, and because banks are often involved in loans and are interested in the risk management that farmers are conducting, this might be a natural kind of fit for options to be offered by banks, so that banks kind of know what kind of risk management programs the producers that they're lending to are engaging in.

The other advantage of having a variety of sources is that you may also have other services that could be combined with option contracts--that an elevator or packers or feed lots or whomever might be able to offer to the counter-party in these contracts.

Another advantage is greater hedging precision. People would better be able to match the size of contracts; they would be able to customize it in terms of commodity grades, locations; they would also be able to offer options on commodities for which there are no exchange traded instruments. And finally, they might be able to combine options together to create things like insurance-type products--revenue insurance-type products, or maybe the simultaneous hedging of inputs and outputs through a single option.

Finally, there's financing flexibility. With an exchange-traded instrument, premiums, margins, things like that have to be paid up front. With a trade option, that



would be up to the parties to decide how payments would be made. So it could be possible that, perhaps, the premium is taken out of the price of a commodity once it's delivered, or it may be able to be delayed or something, so that there may be some possibility of financing the option through the party that's selling it.

Of course, with the benefits there also come added risks with trade options, and we've cited several that we think deserve some consideration. The first risk that we see would be an increased risk of fraud. This could be caused by several reasons; one is the decentralized nature of the market and the lack of a group that would oversee the trading of these options, such as an exchange or a self-regulatory agency. Certainly, the Commission would be there to look at things like fraud, manipulation, things like that, but just because of the decentralized nature of it and the Commission's resources, they certainly wouldn't be able to oversee this market like you would have in the case of an exchange, where you have self-regulatory organization overseeing the market.

You also would have lack of standardization. That means that one person's option could differ quite substantially from another person's option, and it may be difficult to actually judge, you know, how a particular option then works, because they're not standardized. It's not easy to see, oh, well, so-and-so's option works like that, well, mine may not work like that because the terms aren't as standardized. It would also

be--in association with that--there would be a learning curve; it would take a while, probably, before people kind of catch on to the nuances of these contracts and what to expect from them.

Another risk that you have would be an increased credit risk. With exchange-traded products, you have kind of a pooling of risks through the clearinghouse. With off-exchange or trade options, your credit risk depends on the other party; if they're good for it, then the option's good. If they're not, they're not. But you have to make an assessment of what the credit worthiness is of the counter-party to the option.

You also have an asymmetrical risk between granters of options and purchasers. Particularly, when the purchaser of the option pays a premium up-front, he then has to wait before the seller of the option has to make good on his part, so that when you go to exercise it, is the counter-party still going to be there? Or is he going to run off with your premium? So that's a concern, and the problem is that because of the movements in market prices, your counter-party may default as time goes on, and prices move against their position.

Another concern is operational risk, and associated with this is the internal controls. There's a question of how sophisticated the option vendors are, and whether or not they're able to appropriately manage the risk of their aggregate option positions. If they're not managing that risk

very well, then there's a concern that they may default on contracts.

There's also the question of who would oversee risk management by these entities. Questions arise as to whether or not elevators would be required to be audited--things like that--to make sure that they're maintaining some type of internal controls on their risks.

The final risk that we identified is something called systemic risk. And that's a term that's often used in the swap markets, and in that case, they usually refer to the case where one swap party may default to another; that causes that party to default, and you kind of have a chain reaction. Well, you have that same type of risk with ag trade options, and it can be particularly problematic because of kind of the--of what we refer to as rural economies--which tend to be very isolated, very dependent on agriculture. They're not very diversified. So that the problem is if you have an elevator that goes down in a small town, that elevator may be connected to quite a few other parties within the town, and you could have some very severe consequences for these local economies. So that's a risk that would need to be considered, too.

So in looking at these risks, we also tried to identify some possible restrictions that would address these risks.

The first thing we looked at was the nature of the parties. The thought being, if you can make sure that you have a certain level of sophistication or education among the

parties that are entering into these transactions, that that might decrease the chance of some of these other risks, you know, coming into play.

One potential restriction would be a size limitation on the parties or a minimum size to the transaction. So, for instance, if it was a limitation on the party, there might be some kind of a net worth or some kind of measure like that to determine whether a party would be allowed to enter into an option or even for the offerers of options.

Another restriction could be a minimum size of a transaction. That's been a restriction that's actually been used in--there are a couple of staff and Commission no-action letters dealing with trade options, and there was a minimum size for the transactions, I think, on the order of a million bushels or so. Of course, the problem with a restriction like that is that you may limit the availability of options to smaller parties who might find them most useful.

A second approach would be to use some kind of registration, notification or line of business requirement for option vendors. One cut would be to limit it to commercial enterprises within agriculture. In addition, there might be--vendors might be able to offer options if they were regulated by the state, such as a bank or insurance companies.

A third restriction we looked at was an education requirement, where there might be some education requirement either on producers or vendors to participate in some kind of

course or seminar or something on trade options before they would be allowed to engage in them. The problem with this is that it could be a very difficult program to implement. As far as the CFTC goes, there is no program in place at the moment that could handle a large scale education effort of farmers. On the other hand, it could be done through private parties, but again, there'd be problems with monitoring these private parties and you always run the risk that educational seminars turn into marketing seminars and it becomes questionable as to what kind of education might go on.

Another suggestion that we'd heard is that vendors should be required to pass a Series 3 exam, the same way as a broker would need when they offer exchange traded products.

Other restrictions we looked at were on the instruments or their use. Commissioner Dial mentioned that currently trade options are options that are traded between commercial parties or with commercial parties and they're solely for purposes related to its business as such. The question becomes, what would be a legitimate business related purpose?

And whether or not there would be restrictions on how a producer or a feeder would be able to use options. For example, one of the examples I showed you showed the example of a producer selling call options, and the question would be whether the sale of call options from producers is a legitimate business use of an option or not. That is something that we'd need to consider, I think.

Other things that we looked at as far as restricting instruments would be the size of the instrument compared to the underlying cash commodity--whether or not people are hedging two or three times their production or not. And we'd look at things like the expiration of the cash position. For those of you who are familiar with hedged-to-arrive contracts, one of the problems that came up there were the people that were hedged using a nearby futures price for production that was not going to be delivered until future crop years. So there would be some, you know, looking at the timing of the expiration of the contracts with the cash positions.

As I mentioned, the issue of covered call writing. And also restrictions to ensure compliance with the exemption. For example, bundling of options; you could bundle options to look very much like a futures contract, and that would be an issue of how you would distinguish between packages of options and other restrictions on the sale of [inaudible] futures contracts.

We also look at the regulation of marketing. Disclosure is something that occurs routinely with exchange-traded contracts, but with trade options, there are no disclosure requirements at the moment for trade options. And the question is whether there should be similar disclosure requirements for trade options as you would have for exchange-traded contracts. This would include some kind of disclosure of the risks that you might entail in entering into one of

these options; it would have disclosures about the premiums, how premiums are determined, other costs that are associated with the instruments, and things like that. Also a question of whether account information should be routinely reported to option holders. Again, this was an issue we saw with hedged-to-arrive contracts where producers really didn't know where their position stood in these contracts. Whereas, if they'd had some kind of monthly reporting, they may have known earlier on that their positions were basically under water. So we'd be looking at what types of account information and how often things like that should be reported to option customers.

And finally, there were several other possible limitations we looked at. One is the issue of required cover of the market risk. This would be for, for instance, the elevator who has a large short position that it sold to producers--whether or not there should be some requirement, and how that requirement--or what type of requirement would be on them to cover the risk of that position. One of the, in this regard, the exchanges have suggested that all option contracts should be covered one-to-one with an exchange trading contract. Other ways of providing cover would be to have some sort of net capital requirements or something like that. Depending on the size of the position, you could adjust what the capital requirements would be, or it could be some

combination of the two--of cover or some combination of net capital requirements.

The other thing we would look at would be internal control requirements; what types of internal controls should elevators or packers or whomever selling options, what types of internal control should they have in place to make sure that they're adequately managing the risks of those positions.

And that brings up the issue, too, of how you would monitor that. Would they require a CPA to periodically audit them? Would the Commission go in and audit them periodically, or would they review CPA audits, things like that? So that's another issue we'd look at as far as how these entities control their risk.

And I think that's basically all I have, and I guess we'll open it up to questions now that, hopefully, we can address.

MR. DIAL: I'm going to ask you all--if you want to ask a question or make a statement, I'm going to take this mike off of here and move toward the center. If you would please walk up and take the mike, because one of the main purposes of this meeting is so that we can record your questions and your opinions, and then we can make a transcript and it'll become part of the record. So the floor is now open for your questions and/or your comments.

QUESTION: This is Paul Hitch [ph.]. Some of your examples referred to futures contracts; others did not. Is



that intentional that these are not always tied to futures contracts traded on the exchange?

MR. KUSERK: As far as determining or setting the price on the option or exercising the option, typically you need some type of price series that you would be able to look at. I would guess that for most contracts, people would look at the futures prices because those are the most readily available, but certainly, it could be based off of a cash price.

MR. HITCH: Yeah, because the first example was cattle sold at 72 cents a pound, it says nothing about whether the December futures for trading, it just--so I was confused. I didn't know whether futures were an integral part of the option deal or not.

MR. KUSERK: Well, typically the futures prices is going to determine if the--it's going to give you some idea of whether the option is in the money or not. When you go to set the strike price, I mean that simply is determined by the two parties to the contract. So if you want 72 cents a pound, you know, you write that into the contract, and somehow then, you'd have to determine a premium--what's the risk to the short? How much is he potentially going to have to pay you. I mean, if it's a put option and cattle's only selling for 50 cents a pound, well, then, you're going to pay quite a premium to be able to deliver it to him for 72 cents. But typically, what'll happen is that you'll get to the exercise period, the

future's price, theoretically, comes down to the cash price, and you're looking at some type of a cash price--

[Technical Interruption. End Side A.]

MR. KUSERK: --exercise period, you would look at that to determine how much your option's in the money. Now, in reality, for you, it's going to depend upon what your cash price is. Your cash price is probably going to be based off of the future's price, maybe higher, maybe lower. But if it was a cash settled contract, for instance, though, they'd probably look to the future's price since you have a more liquid price there that they could look at--or a price series that you could look at. But, yeah, ultimately, if it's a physical delivery contract, it's really going to come down to the price that you're actually going to receive as to whether or not you exercise that option or go find somebody else to sell to.

MR. HITCH: Thanks.

QUESTION: I'm James Herring from Texas. Greg, I know there is a flourishing marketplace in off-exchange transactions called the derivative market in the financial and currency area. Would you tell us how this differs--these ag options would differ? Answer it in terms of--you stated that those transactions are considered illegal.

MR. KUSERK: Which ones are--

MR. HERRING: Ag options.

MR. KUSERK: Okay.

MR. HERRING: And so the question boils down to, are we here to advise you as to whether we, as an industry, think they should be legal? And secondly, if so legal, then regulated by some supervisory, governmental agency?

MR. KUSERK: I think that's exactly what we're looking for.

MR. HERRING: Okay.

MR. KUSERK: And not only regulated, but what types of regulation do you think are needed in the [inaudible]

MR. HERRING: All right. Tell me how the derivatives marketplace in financials and currencies is regulated currently?

MR. KUSERK: Well, I guess, for the most part, if you're looking at the off-exchange markets, you would have--it would depend, you have several regulators that might be involved. You'd have the Securities Exchange Commission, you'd have banking regulators, and to some extent, you'd probably also have the Treasury Department that regulates different entities within those markets as to what they can do. The instruments themselves? Typically, I don't believe the instruments themselves are regulated, but it's more so that the entities involved fall under somebody's jurisdiction--like I said, most commonly the SEC or the banking industry.

MR. HERRING: Well, I guess what you're saying is there's really not specific regulation of a particular bank in formulating these derivative products.

MR. KUSERK: As far as designing the specific contracts?

MR. HERRING: Yeah.

MR. KUSERK: Yeah, for instance, with stocks, no. That's typically not the case. It's between the counter-parties.

MR. HERRING: Are you at all trying to compare that marketplace with what you're suggesting to exist in the ag arena, and if so, what's happened in the derivatives marketplace that should worry us about allowing these off-exchange transactions to take place in the farming community--livestock?

MR. KUSERK: All right. I don't know that we're looking, necessarily, to the same level of regulation--and I mean, I think that what we're trying to get is an idea of what farmers want--whether they want a heavily regulated off-exchange market, or whether they want a more, kind of wide open-type market. Certainly, we could lift the ag option ban, and have very specific regulations about the types of instruments that could be traded, or the types of disclosures, things like that that would need to go on. Or, to be just left more up to the two parties to work it out, and in the case where problems develop, it would be up to the parties to settle those problems, although, like I said, in the case of fraud or something like that, the Commission would still have jurisdiction in that area, but it may be left more to private litigation to resolve differences in contracts; more like what you have in the case of the forward contracts when problems

develop. I don't know that we're really proposing anything right now as to how the regulations will occur; we're looking more for input as to what the industry would like to see.

MR. HERRING: Is it the CFTC's position that the hedged-to-arrive contracts that were made during last spring are illegal?

MR. KUSERK: I think you really have to look at the specific situations with different contracts. I think that--the Commission has brought several actions against the people that offered hedged-to-arrive contracts, and I think there are three enforcement cases, at the moment, that are active. In other cases, the way the hedged-to-arrive contracts were used really appeared to fit within the forward contract exclusions, so it really depends. You have to really look at those, one from the other. They really differed between the different cases as to how they were used and what they [inaudible]

MR. HERRING: Take an example of a case that you're pressing currently, and tell us what you think was wrong about it.

MR. KUSERK: Well, I think the biggest problem that we saw, particularly with hedged-to-arrive contracts, were cases--and we put out this guidance last May--basically, looking at contracts where people had multiple crop years hedged, using nearby futures prices, and involving contracts that had no firm delivery obligation in them; they could be rolled

perpetually. Those were the types of contracts that we saw where we took action against them.

MR. HERRING: And it was a case of fraud on the writer of the contract? Or misunderstanding or fraud on the acceptor of the contract or--

MR. KUSERK: In one of the cases, we did charge fraud. It wasn't as clear in the other cases that there was actually fraud going on or--there was just more of a misunderstanding as to the specifics--particularly with the rolling provisions of the contract.

QUESTION: My name is Laurie Cohen, and I've been a professional options trader in Chicago for the past ten years, and I'd just like to make a few comments on my reaction to these options, and then ask a question.

First of all, as an options trader, there are several components that I feel are essential to have a beneficial option market. You need to have a liquid market; that is, a market that you can get in and out of. If I buy a call or a put from somebody and halfway through it, I decide that possibly I don't need it, I don't want it anymore, I want to liquidate it; I want to get out of it. If you do that, you need to have the opposite side of it, or other participants in the market have to be willing to allow you to liquidate it.

Second, it's important that you have a market where there is price transparency. That is to say that everybody knows what prices are being offered, and at what price you can buy

or sell an option. The valuation of an option is a very critical component and can--you need to have people who know how to value the option. I think that was a big problem with the hedged-to-arrive contracts.

Furthermore, these prices of the options need to be disseminated; they need to be made available. With off-exchange options, that's a concern of mine.

Third, there is counter-party risk, the risk that the other side is not going to pay up or deliver. And with an exchange--options that are traded on exchange--the clearing firm takes the opposite side to it.

Fourth, the regulation is very critical. There, as you say, with exchange-traded options, they are both regulated--they have some self-regulatory organizations as well as the Commission. With non-standardized options, the regulation becomes much more time-consuming, just as you said, with each of these hedged-to-arrive contracts, each one of them was different. Therefore, each one of them has to be studied individually.

I think you mentioned that there would be financing flexibility. Well, that was what the grain elevators offered, but then it ended up to be a fiasco when the actual termination of the--well, there was no real set expiration date because many of them could be rolled indefinitely.

The question that I have and that really concerns me about them is, who is going to regulate them? How--what kind

of a system is going to be set up to regulate these numerous, non-standardized contracts--each one of them different? Another--from a regulatory perspective--a big problem I see is, if the person who sells a call has to match his cash market position with the call that he has sold or the put that he has sold, constantly you'd have to be monitoring when he sold his cash product, and what his position is with respect to the option. And who's going to pay for this? I see it as very costly, and I just wonder, you know, what thought has been given to that, and what mechanisms possibly exist to finance the regulation.

MR. KUSERK: As far as the first points you raised, I think you're right. Transparency is an issue, although depending on the types of contracts that are issued, it may be not much different than what you'd have with forward contracts, in which case, the exchange really winds up providing the transparency for the prices. To the extent that trade options being offered match more or less the terms that are being offered on the exchanges, except for their privately negotiated contracts.

Liquidity is certainly an issue. As you mentioned, you have to go back to the original counter-party to try to get out of your position. I forget your other two points, but--I think you're right on--

As far as who would oversee it, that is a difficult issue; that is something that we would have to look at, as I



said. Whether or not there would be some type of periodic audit or something that the sellers of the options or vendors would have to go through to make sure that they had some type of risk management or internal control set-up to monitor their positions, things like that. And, it's possible that the Commission would periodically check different vendors, or look at audits that were done. Certainly, you wouldn't have the level of scrutiny that you would have in the exchange markets, because as you mentioned, they do have self-regulatory organization involved there; you have the associations--the NFA involved. One possibility that has been raised is whether or not the NFA might get involved somehow in trade options. That's something that we haven't explored in great depth yet, but that's something that we're also considering, too, as to whether some type of organization or association could be set up to oversee the markets.

As I said, this is--we're trying to collect input on this and determine what levels people need, and certainly, these are issues we have to look at--the expense of trying to regulate such a market.

MR. HITCH: Does it need to be regulated? I mean, I guess all the--to advance the theoretical argument that, if Hitch Enterprises wanted to go to a packer and contract to deliver cattle for 72 cents today, that's unregulated, and it's completely legal, or at least--maybe it's regulated by the Packers and Stockyards Administration, but as a forward

contract, it's not particularly regulated. What we are not doing is getting an option to deliver on the 72 cents.

MR. KUSERK: That's right. I mean, you do have people entering into forward contracts all the time with no real regulatory structure in place there, and the question is whether or not you would do options in the same place or the same way, in which case, you wind up in private litigation when problems arise. I mean, there might be some state involvement or something that looks at contracting or whatever--you'd look at state contracting laws and things like that, but that's right; that's the other side of it--whether you do need that level of regulation.

QUESTION: I sort of came in a little late--maybe the question's already been asked, but my question is--

MR. DIAL: Could you identify yourself?

MR. HANNAH: Kirk Hannah, Colorado. Historically, do options have a positive or negative bias on the commodity? Can you comment on that?

MR. KUSERK: I don't know that we know that they either--well, I guess, the trade options themselves--trade options in agricultural commodities, have not been around for 60 years--they were banned, I think, in 1936, initially. So, I mean, the only example you have then would be to look at exchange options, and I guess my personal view would be that they probably don't bias the prices either way. That would be my

personal view, though. But I don't know of any studies that show that they bias it in one way or the other.

QUESTION: I'm Don McCaslan [ph.] from Clovis, New Mexico. Commissioner Dial, my thoughts on it would be--it would be almost impossible to regulate it. You'd have to have a hundredfold budget than what you have now to do that. I give a lot of seminars in the country, and the lack of understanding on these options is very critical, and I find the banks the least understanding of all. I don't believe that it's a viable option to do this. I think you'd make a heyday for attorneys, and I just think, you know, the level of knowledge out there is low. Even though the Merc has gone to a lot of trouble to educate people on it, the level of knowledge it is still low on it. I think you're looking for a lot of trouble if you did that.

However, as we look at some of the bigger elevators or the packers and the more sophisticated operators--some of these could probably handle it. But you've already had the experience with the hedged-to-arrive, and you know what happened there, and I--but I'm a little bit torn in saying all of this because I see that the live cattle contract, for instance, the one that I'm more involved in than anything, it seems that it's meeting the needs of the producer in a lesser fashion now than it has in the past. I feel that the Merc is a little bit less responsive to the producer and not really addressing some of the needs that we're trying to express to

them, such as convergence, you know. We have to ask ourselves right now, are these contracts for the speculators in Chicago, or are there for the producers? And I know it takes both to make a trade. And I think we have to look and see just what the contracts are really for, and are they really meeting the needs of the producer? We've got early expiration of the options right now around the 5th of the month, and that's an improvement over what it used to be, but we're sitting here three and four weeks--three weeks--out with no protection at all. We pay the premium but don't get the protection at the end. And so, if I was dealing straight with the packer, maybe it would be a little different. In other words, I guess what I'm saying is no competition to the Merc, and maybe that's fine--maybe we don't need any--but, I feel like they have to be a little more responsive to the producer at this point in time. That'd be my thoughts. Thank you.

MR. DIAL: Any other questions or comments?

MR. HERRING: Commissioner Dial, I'm James Herring from Amarillo, and I was speaking earlier as a cattle feeder, and now I'd like to speak just for a second as the president of Texas Cattle Feeders.

We are, I guess, a group of very independent-minded people down there in the Texas panhandle, and certainly, I guess you could call us laissez-faire, if you could call anybody that. But I do think we have great reservation in these contracts, as I've stated before. The comparison with

the derivative market and what's happened there causes a lot of concern. If professionals and CFOs of Proctor and Gamble are having trouble with these things, we think the general cattle feeder and agricultural person out in the field would certainly have problems as well.

Ms. Cohen's comments about liquidity, tradeability, standardization--all of those things--give us cause [sic]. We met in a summer meeting in Colorado Springs and did decide that, although we were not particularly for creation of this vehicle, we would not oppose it at this time, but certainly--certainly--we would encourage some form of regulation. Now Don makes a good point here, because regulation costs money and takes people and takes budgets and takes commitment, and we wonder if that's even remotely feasible in today's marketplace.

So I hope that you will consider these comments. I hope that we can go forward in discovery, and we'd love to hear more about pros and cons here. But it gives us great pause, I think.

MR. DIAL: In that regard, the transcripts of the public meeting in Bloomington, Illinois and the other one in Memphis are available. As a matter of fact--have we put those on the internet, on our home page--if they're not on there now, they should be on there shortly, or you can call my office or call the Commission, and we'll be happy to send you a copy because they are a matter of the public record, and you can see what

the commentators [sic] at those open meetings had to say about their views on prohibition of agricultural trade options. And there were both sides--pros and cons.

MR. HERRING: James Herring again. I do want to take this time to thank you and Greg for coming all this way to visit with a relatively small crowd here representing the cattle industry. Thank you so much for doing that.

MR. DIAL: It's our pleasure.

Sir, you have a question? Would you please come forward and take the mike?

QUESTION: Yeah, thank you, Commissioner. My name is Jim Hoffman from Fort Pierre, South Dakota. What my feelings are is that with the ag on the world-competing market with each other, I think that we ought to have our commodities run just like our New York Stock Exchange. If you're going to buy--if we've got a billion cattle out there, you sell that many shares, instead of four or five times that amount. And you pay the full price of that share, whether it's \$10.00 a share or 40 cents. So you've got the full investment in that and not a fraction of it so you can play the game from both sides, thereby the speculators that are watching you as a big player, and they'll follow your leaders. And I think, from the point of view of a producer, this is where most of our trouble is beginning. Like it was stated earlier, who is this trying to benefit--the producer or the trader or the speculator or the end producer? So, in all sincerity, I think to make

agriculture competitive to feed the world in being the United States with the high standard of living, we need to have security in here so we're not just being low bidder and not talking apples to apples. We might have good quality stuff here and our other competitor may have poorer quality, but we've got to compete with that mass of apples--regardless what the grade of it is.

So I think this deal here would be a great injustice to our present system. But on this same token, I think our present system needs a lot of revamping. Thank you.

MR. DIAL: Anyone else? Yes, sir.

QUESTION: My name is Merle Carlin. I'm also from South Dakota. I guess my greatest concern, as I'm listening here today, is to deal with the transparency issue, and the reporting of trades. We're sitting here in the cattle industry already wrestling with the problem of captive supplies, and here we have another potential of a large amount of captive supplies that may come into the market, particularly with the call options, and at least if they're reported, you would know that--[inaudible]--you wouldn't be blindsided by them. And that's my greatest concern is what effect something like that may have on our cash market.

Thank you.

MR. DIAL: Anyone else?

Well, thank you all very much for being here and giving us the opportunity to present this information and also for

expressing your views. As I said, the comment period closed on July 24, but nonetheless, if you have some thoughts after you go home about this, don't hesitate to drop us a note.

To refresh your memory on the comments that I made in my presentation, what will happen now is that the Division of Economic Analysis that Greg is a part of will take all of the comments that we've received in the three public meetings that have been held and all of the comment letters that we get in; they'll go through those, and they will develop a paper on that input. They will submit it in draft form to the Commissioners--the Commission as a whole. Then the Commissioners will decide whether or not they want to move forward with a proposed rulemaking and if so, what will be in that proposed rulemaking.

If the Commission makes the decision to take that step, then it will be published in the Federal Register, and there will be a comment period for people to comment on the proposed rulemaking. After that comment period is over, they'll go through the same exercise--the Division of Economic Analysis will review all of those comments; will submit a draft paper to the Commission; the Commission will decide whether or not, at that point in time, it is going to lift the ban, it is not going to lift the ban, or it's going to lift the ban with certain restrictions. In either event, an announcement will be made in the Federal Register. So there's ample time for comment. We earnestly want your points of view and your



participation in this because the Commission does not want to do anything that would be disadvantageous to American agriculture.

So once again, thank you for coming. Greg and I will be here for a while longer. If any of you want to come up and visit, we'd be delighted to do so.

Thank you.

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